Firm Ownership Type, Earnings Management and Auditor Relationships: Evidence from India

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I. Introduction

The importance of external auditing as a mechanism for corporate governance has attracted considerable attention of late. Academics and policy makers in both developed and emerging markets are increasingly grappling with this issue as they seek to reform their governance mechanisms, particularly in the wake of the recent accounting irregularities in the US and the subsequent financial meltdown.

The present paper examines this issue in the Indian context, drawing upon available theoretical and empirical literature. Towards this end, the study explores the association between external auditors and non-financial (manufacturing) firms. More specifically, we focus on two issues. First, we investigate whether firm ownership type matters for auditor choice, an aspect not previously addressed in the literature. Second and borrowing from the literature, we focus on whether earnings management impinges on auditor behavior.

The dataset includes information on non-financial firms for the year 2005. The data includes measures of firm characteristics, performance and ownership. The data are matched to information on the identities of auditors with which these firms have relationships. In case a firm has multiple auditors, the data also provides the names of these auditors listed in order of priority (main auditor, second auditor etc.).

The paper makes several contributions. First, to our knowledge, this is the first study for India to examine how agency conflict affects the choice of auditors and audit fees. A second contribution of the paper is purely methodological: utilizing different types of models to ascertain the interplay of auditor choice and firm ownership. Third, akin to Fan and Wong (2005), the paper contributes to the governance literature by linking external audits with firm ownership. Auditor types, audit fees and opinions provide good quantifiable measures of quality of this governance mechanism.

II. Auditing process in India: An overview

Following independence in 1947, an Expert Committee was constituted to examine the scheme of an autonomous association of accountants in India, which led to the enactment of the Chartered Accountants Act (1949) and establishment of Institute of Chartered Accountants of India (ICAI) in the same year. The Chartered Accountants Act governs the accountancy profession in India. A broad revision of the legislative framework relating to the accountancy profession has been undertaken recently, primarily in the wake of the accounting irregularities in the US. Towards this end, the Chartered Accountants (Amendment) Act 2003 has been passed by the Indian Parliament which seeks to

reconfigure the current regulatory regime and the disciplinary arrangements relating to the accounting profession.

The Companies Act of 1956 governs the form and contents of balance sheet and profit and loss accounts of limited-liability companies. The Act requires the preparation, presentation, publication and disclosure of financial statements; and an audit of all companies by a member-in-practice certified by the ICAI. Schedule VI of the Act prescribes the form, content and minimum disclosure requirements of financial statements. Amendments to the Act, most notably in 2001 and 2002 included, among others, incorporation of directors' responsibility statements in the board's report, prescribe voting through postal ballot and delimiting the number of companies in which a person can hold directorship.

As regards ensuring compliance with auditing standards, the Ministry of Corporate Affairs enforces regulatory norms and takes action against any non-compliance. The two primary stock exchanges, the Bombay and National Stock Exchanges rely on external auditors to monitor compliance with the accounting and disclosure requirements.

III. Review of literature

Several studies have explored the association between auditor choice and agency problems for the US (Francis and Wilson, 1988; DeFond, 1992) and other developed economies such as UK (Chan *et al*., 1993), Australia (Francis, 1984) and Canada (Chung and Lindsay, 1988) and to a lesser extent, the East Asian economies (DeFond *et al.*, 2000). A common thread running through these studies is the linkage between auditor choice and firm characteristics such as size, leverage and ownership. Most of these studies veer around the view that large firms tend to hire large and/or brand-name auditors.

Despite its long history, there have been limited efforts to systematically examine the factors influencing auditing practices in India. Early studies (Simon *et al.*, 1986) found firm size and age to be relevant factors influencing audit fees. More recently, utilizing data on a cross-section of listed Indian manufacturing companies, Ghosh (2007) examined the association between managerial (internal) monitoring, external monitoring (proxied by the number of auditors) and firm valuation. The findings revealed that internal monitoring and external monitoring were inversely related. More importantly, the analysis indicated that external monitoring led to an enhancement in firm value. Subsequently, using a sample of non-financial companies, Sarkar *et al.* (2008) found earnings management to be lower for firms having more diligent boards. Whether or not firm ownership impinges on auditor choice has not been empirically explored hitherto, which is one of the major concerns of the paper.

The empirical analysis comprises of several models to test the hypotheses regarding firm ownership type and auditor-firm relationships. The testable hypotheses are as follows.

Choice of main auditor

By helping to prevent the detection of any expropriation of corporate resources for political purposes, there is a less odious reason that state-owners may avoid choosing the brand-name auditors. Consistent with evidence proffered by Faccio's (2007) that political connections afford firms access to cheap loans, Wang *et al*. (2008) argue that state-owned enterprises are more likely to engage lower-quality auditor since, they can raise capital through these connections without having to reduce information asymmetry with more credible financial statements, a fact corroborated by Chaney *et al.* (2010). Taking clue from these findings would lead to the following:

H1: *Domestic auditors are more likely to be associated with state-owned firms*

Audit fees

The determinants of audit fees have been widely discussed in the literature. Summarizing the literature, the evidence appears to suggest a positive relation of audit fees with firm size (Simon *et al*., 1986) and gearing (Sandra and Patrick, 1996), with complexity of firm operations (Collier and Gregory, 1996) and profitability (Simunic, 1980; Chan *et al*. 1993). An aspect not adequately addressed in the literature has been the interlinkage between ownership and audit fees. Consistent with this line of research, we posit the following:

H2: *Audit fees are likely to be lower for state-owned firms*

Multiple auditors

The issue of multiple auditors has not been adequately addressed in the literature, although some recent research explores this issue. Using a sample of over 850 firms for1981-88, Davis *et al.* (2009) finds that auditor tenure is typically lower for firms with multiple as opposed to single auditors. The factors as to why firms employ multiple auditors and its interface with firm ownership has not been previously examined, which is one of the aspects being examined in the study.

Earnings management

Focusing specifically on auditing and earnings management, studies have found that the level of earnings management is inversely related to the extent of audit committee independence (Xie *et al*., 2003). In this article, we examine whether earnings management has an effect on auditor choice and how it impacts audit fees.

An important aspect of the auditing aspect is its interface with firm ownership. Although the possibility of principal-agent conflict exist both in state-owned and privately-owned companies, it is often relatively more difficult to address the agency problem in the former as compared to the latter since the controlling owners are themselves agents of the actual owners: the state. The balance of evidence indicates that firm ownership matters for earnings management. By way of example, in case of Chinese listed companies, the findings suggest that when ownership concentration level is low, the

agency costs are high (Ding *et al.*, 2007). This concurs with previous studies which report that family firms exhibit less discretionary accruals (Ali *et al*., 2007; Hutton, 2007). More recent cross-country research on private firms in six European countries indicates that privately held companies engage less in earnings management when they have brand-name auditors (Tandeloo and Vanstraelen, 2008). Borrowing from these findings, we propose the following hypotheses:

H3: Domestic auditors are less likely to be associated with firms having higher earnings management, and

H4: Audit fees are higher for firms with higher earnings management

IV. Research method

To examine the hypotheses outlined earlier, we propose several reduced form equations. The first specification examines the determinants of firm's choice of domestic auditor. Accordingly, we utilize the following specification:

Main auditor type=f1(firm characteristics, firm performance, firm ownership, earnings management variable, industry dummies) **(1)**

The dependent variable (i.e., main auditor type) is a dummy which equals one if the main auditor is domestic, else zero. Among the controls, we include various firm-level characteristics such as size, age, operational complexity as well as controls for performance, such as profits, leverage and asset tangibility. In all cases, we run the regressions with and without the firm ownership to ascertain whether firm ownership influences auditor choice. The estimations also include controls for the firm's industry group. We estimate equation (1) by logit specification.

The second specification analyzes the determinants of multiple auditor relationships and the number of such relationships to test the hypotheses about the effects of firm ownership type on such relationships. For this, we employ ordered logit technique. Accordingly, the dependent variable is a dummy which equals zero if the firm exhibits single auditor relationship, one if the firm is associated with 2 auditors (given that the average number of auditor-firm relationships is 1.54) and two, if the number of auditor-firm relationships exceeds two. Multiple auditor relationship is modeled as a function of firm characteristics, firm performance, firm ownership as well as auditor characteristics, in addition to industry dummies as given by expression (2):

Multiple auditors (dummy or number) =f2(firm characteristics, firm performance, firm ownership, auditor characteristics, earnings management variable, industry dummies) **(2)**

As regards number, we estimate (2) by Poisson estimation to ascertain which characteristics affect firm auditor choice. Among other characteristics, we include the earnings management variable to understand whether a firm employs multiple auditors to engage in opportunistic behavior.

The third specification examines the determinants of audit fees. Accordingly, we employ the OLS regression to test the empirical specification as given by eq. (3):

Ln Audit fees =f3(firm characteristics, firm ownership, firm performance, auditor characteristics, earnings management variable, industry dummies) **(3)**

V. Database and summary statistics

We match data on non-financial firms and auditors with which they have relationships. The database employed in the study is the *Prowess* database (Release 2.5), generated and maintained by the Centre for Monitoring the Indian Economy (CMIE), a leading private think-tank in India.

The selection of the sample is guided by the availability of data. We proceed in several stages for the selection of sample firms. In step one, we cull out information on all manufacturing firms for the year 2005 that are listed on the National Stock Exchange [5]. This, in effect, provide us with disaggregate information on 697 firms.

Table 1 reports the summary statistics. The first set of variables includes firm characteristics. These include firm size and age. The age of sample firms ranges from 3 to 142 years, with an average (Ln) age of 1.41 years.

Table 1: Variable definitions and summary statistics

Variable	Empirical definition	Mean	Std. Dev.
Firm characteristics			
Ln asset	Natural logarithm of total asset	2.553	0.594
Ln age	Natural logarithm of number of years since incorporation of the firm	1.409	0.299
Business group	Dummy variable=1 if a firm belongs to business group	0.644	0.299
Overseas	Dummy=1, if a firm has made an overseas equity issue, else zero	0.034	0.182
Subsidiaries	Numerical variable equal to the number of subsidiaries	1.485	2.489
Firm ownership			
State	Dummy=1, if a firm is state-owned, else zero	0.029	0.169
Foreign	Dummy=1, if a firm is foreign-owned, else zero	0.065	0.247
Indian	Dummy=1, if a firm is Indian private-owned, else zero	0.252	0.434
Firm performance			
RoA	Operating profit/total asset	0.056	0.133
Leverage	Long-term debt/Total asset	0.377	0.452
Tangible	Plant, property and equipment/total asset	0.633	0.412
Auditor relationships			
Auditors	Numerical variable equal to the number of firm-auditor relationships	1.543	1.501
Domestic	Dummy=1, if the primary auditor of the firm is domestic, else zero	0.794	0.405

We include one measure of access to non-bank external finance. Accordingly, we also include a dummy for firms that belong to Indian business groups (*Business group)*, which comprise 64% of the sample firms.

We also include the number of subsidiaries (*subsidiaries*) to capture the organizational complexity of firm operations (Craswell *et al*., 2002). The maximum number of subsidiaries was 17, with an average of 1.49; 22% of the firms had at least one subsidiary. A firm's demand for external auditors may be related to their overseas equity issue. To control for this possibility, we include a dummy variable *Overseas*; 23 firms had made an overseas equity during the last five years.

The second set of variables focus on dummies that classify firms by ownership. Accordingly, we distinguish between state-owned (*state*), foreign-owned (*foreign)* and Indian domestic private (*Indian*) corporates. Foreign-owned firms may have access to cheaper financing *via* the parent firm and state-owned firms may secure financing by virtue of their implicit government guarantee. In the sample, 3% of the firms are state-owned, 7% are foreign-owned and 26% are domestic private entities.

The third group of variable measures firm performance. We include return on asset (*RoA*) and long-term debt to total asset (Craswell *et al.,* 2002; Fan and Wong, 2005) as the measure of leverage. The average RoA is 0.06 and the average leverage ratio was 0.38, respectively. In addition, we capture firm opaqueness by its asset tangibility. Following Kroszner and Strahan (2001), we measure tangibility of asset (*tangible*) as the ratio of plant, property and equipment to total asset. The average asset tangibility of the sample firms was 0.63. Finally, we include the firm's current asset ratio (*current*).

The final set of variable focuses on firm-auditor relationships. Around 9% of the firms have multiple auditor relationship, the remaining have relationship with a single auditor. The average number of relationships per auditor is 1.54 with a high of 5. We also include a dummy if a primary auditor is domestic, else zero. Nearly 80% of the firms have a domestic auditor as the primary auditor. The final included variable is auditor fees. The average level of auditor fees is Rs. 1.75 million (≈US $0.04 million), with a high of Rs. 4.5 million (≈US $ 0.1 million); auditor fees are not reported for 68 (or 10%) of the firms.

We also include controls for the firm's industry type. Accordingly, we employ dummies for 11 industry sectors: these include, food, textiles, chemicals, electronics, machinery and tools, drugs and pharmaceuticals, cement, plastic and rubber, auto and auto ancillaries, diversified and others.

VI. Results and Discussion

VI.2 Determinants of domestic auditor

Table 2 shows the results for the determinants of domestic auditor by firms. Across the first three specifications, the coefficients on *Ln(asset) and Ln(age)* are both negative and statistically significant. This suggests that it is the smaller and younger firms that are most likely to be associated with domestic auditors. When we augment the base model (Model 1) with *overseas* (Model 2) or *subsidiaries* (Model 3), neither of these variables are statistically significant at conventional levels. In other words, choice of domestic auditor by firm is not influenced by either its overseas operations or alternately, its number of subsidiaries.

We next address the question whether firm performance affects auditor choice. Across the first three models, most of the firm performance variables are statistically insignificant, which tends to suggest that firm's choice of auditor has little to do with its performance. The coefficient on *current* is negative. A low current asset ratio could be indicative of liquidity problems, which lowers the likelihood for domestic auditors to be associated with such firms. The complete model inclusive of firm ownership (model 4) reveals that the coefficient on *leverage* is positive and (weakly) significant, consistent with Ashbaugh and Warfield (2003) that higher debt levels raises financing risks, impelling firms to demand better quality audit services, and thereby inducing them to rely less on domestic auditors. Across all the four models, the coefficient on discretionary accruals is negative and significant at the 0.01 level.

The fourth model includes firm ownership variables to ascertain whether firm ownership affects auditor choice. The coefficients on both *foreign* and *state* are negative and strongly significant, which suggests that both foreign as well as state-owned corporate houses are less likely to be associated with domestic auditors.

VI.3 Determinants of multiple auditor relationships

Table 3 shows the regression results for the determinants of whether the firm exhibits multiple auditor relationships and the number of such relationships. In both the ordered logit and Poisson regression models, we run the model with and without the firm ownership variables in order to ascertain if firm ownership considerations are an important factor in influencing number of auditors. The results suggest that the coefficients on firm ownership are strongly significant, and its inclusion improves the pseudo-R^2 substantially in both cases, In other words, ownership considerations are important role in the choice of multiple auditors by firms.

We also test whether multiple auditors are more likely for firms with high discretionary accruals. Across the Poisson models, the coefficient on this variable is negative and strongly significant. Given the large number of smaller audit firms, mostly domestic, involved in the audit process of mid-sized firms and the traditional vouching-based audit approach followed, it seems that such firms are not adequately equipped to understand the nuances of earnings management. As a result, the number of auditors is lower for such firms.

Following from our earlier discussion, we also estimate the model by NB procedure. The results (model 3) are qualitatively similar to those obtained in the Poisson model. In this case, it is observed that the coefficient on leverage is negative and weakly significant at the 0.10 level, suggesting that higher leverage deters multiple auditors to be associated with firms.

Table 3: Logit model of the choice of domestic auditor

	Model 1	Model 2	Model 3	Model 4
Constant	5.119	5.107	5.108	6.373
	(0.986)***	(0.993)***	(0.989)***	(1.089)***
Ln asset	-0.662	-0.611	-0.578	-0.923
	(0.197)***	(0.201)***	(0.209)***	(0.257)***
Ln age	-0.811	-0.851	-0.825	-0.641
	(0.456)*	(0.462)*	(0.467)*	(0.479)
Business group	-0.344	-0.318	-0.306	-0.959
	(0.245)	(0.246)	(0.247)	(0.375)***
Overseas		-0.557	-0.541	-0.270
		(0.491)	(0.488)	(0.478)
Subsidiaries			-0.063	-0.003
			(0.125)	(0.127)
Debt/asset	1.283	1.303	1.300	1.610
	(0.962)	(0.966)	(0.964)	(0.882)*
RoA	-2.137	-2.224	-2.242	-2.618
	(1.413)	(1.418)	(1.417)	(1.512)*
Tangible	-0.141	-0.193	-0.255	-0.321
	(0.431)	(0.436)	(0.430)	(0.474)
Current	-1.005	-1.046	-1.119	-0.885
	(0.681)	(0.689)	(0.686)*	(0.715)
Disc. Accruals	-0.0005	-0.0005	-0.0005	-0.0004
	(0.0002)***	(0.0002)***	(0.0002)***	(0.0002)***
Foreign				-2.536
				(0.495)***
State				2.067
				(1.144)*
Pseudo R-squared	0.114	0.115	0.116	0.189
Log likelihood	-284.943	-284.322	-284.204	-260.902

Robust standard errors within brackets

***, **and * indicate statistical significance at 1, 5 and 10%, respectively

VI.4 Determinants of audit fees

Table 5 displays the results for the factors influencing audit fees. We include auditor characteristics in addition to firm performance and characteristics variables and run the regression results with and without the firm ownership dummies – an aspect not addressed in previous studies.

In the first model, the coefficient all the firm characteristic variables are strongly significant and exhibit expected signs. Thus, *Ln asset* and *business groups* are positive and significant, suggesting that audit fees are typically higher for large firms and those with group affiliations. The organizational complexity of large firms and those with group affiliations with multiplicity of services across different groups might be the key factor for this result. The positive coefficients on *Ln age* and *overseas,* on the other hand, indicate that older firms and those with higher organizational complexity are more likely to pay higher audit fees.

Table 4: Determinants of multiple auditor relationships

	Model 1	Model 2	Model 3
	Ordered logit	Poisson	Negative binomial
Constant		-0.079 (0.089)	-0.077 (0.081)
Ln asset	0.798 (0.343)***	0.065 (0.033)**	0.066 (0.032)**
Ln age	-0.007 (0.516)	0.008 (0.039)	0.009 (0.031)
Business group	0.209 (0.448)	0.008(0.027)	0.007 (0.021)
Overseas	0.844 (0.575)	0.103 (0.089)	0.101 (0.078)
Subsidiaries	-0.172 (0.183)	-0.006 (0.016)	-0.002 (0.011)
Debt/asset	0.873 (0.618)	0.020 (0.013)	0.018 (0.011)*
RoA	0.714 (1.706)	0.052 (0.074)	0.047 (0.066)
Tangible	-0.318 (0.490)	-0.005 (0.030)	-0.040 (0.022)
Current	-1.528 (0.814)*	-0.077 (0.055)	-0.063 (0.049)
Disc. Accruals	-0.001 (0.001)	-0.001 (0.0007)*	-0.001 (0.0006)*
Foreign	-1.388 (1.145)	-0.040 (0.049)	-0.033 (0.021)
State	0.602 (0.939)	0.120 (0.115)	0.100 (0.105)
No. of Obs.	617	617	617
Pseudo R-square	0.094	0.0031	0.0026
Log likelihood	-185.125	-656.725	-655.622

Robust standard errors within brackets

***, **and * indicate statistical significance at 1, 5 and 10%, respectively

Table 5: Determinants of audit fee

	Model 1	Model 2	Model 3	Model 4
Ln asset	0.586 (0.034)***	0.552 (0.031)***	0.546 (0.030)***	0.619 (0.029)***
Ln age	0.261 (0.058)***	0.206 (0.053)***	0.205 (0.053)***	0.219 (0.053)***
Business group	0.107 (0.037)***	0.095 (0.033)***	0.095 (0.033)***	0.065 (0.037)*
Overseas	0.233 (0.068)***	0.189 (0.063)***	0.182 (0.064)***	0.138 (0.063)**
Debt/asset	0.169 (0.080)**	0.133 (0.072)*	0.129 (0.071)*	0.112 (0.069)*
RoA	0.111 (0.169)	0.025 (0.149)	0.022 (0.147)	0.011 (0.144)
Tangible	-0.095 (0.052)*	-0.080 (0.049)*	-0.079 (0.049)*	-0.105 (0.046)**
Current	-0.280 (0.101)***	-0.209 (0.092)**	-0.214 (0.091)***	-0.203 (0.087)**
Disc. accruals	0.005 (0.002)**	0.001 (0.001)	0.001 (0.002)	0.001 (0.001)
Domestic		-0.382 (0.029)***	-0.388 (0.029)***	-0.330 (0.032)***
No. of auditors			0.063 (0.42)	0.080 (0.042)**
Foreign				0.174 (0.071)***
State				-0.518 (0.078)***
Constant	-3.207 (0.129)***	-2.681 (0.126)***	-2.728 (0.130)***	-2.983 (0.129)***
No. of Obs.	593	593	593	593
Pseudo R-square	0.548	0.626	0.628	0.657

Robust standard errors within brackets

***, **and * indicate statistical significance at 1, 5 and 10%, respectively

The important consideration is the impact of firm ownership on audit fees. The findings indicate that the coefficient on state-owned dummy is negative, while that on *foreign* is positive. Both these variables are significant at the 0.01 level. The audit fees for state-owned companies are typically prescribed by the Government, which are often below competitive (market) rates. The sign on *state* is consistent with this observation. On the other hand, the trans-national presence of foreign firms necessitates them to follow international accounting standards. Combining with table 3, this indicates that such firms are less likely to engage the services of domestic auditors. Audit fees paid by these firms are consequently higher *vis-à-vis* their Indian private counterparts.

VII. Concluding remarks

The study examines the factors influencing auditor-firm relationships in India. More specifically, we test several hypotheses about the links between firm ownership, auditor relationships and earnings management. After taking into consideration various firm-level controls, the salient results that emerge include the following.

First, the findings indicate that firms having high discretionary accruals are less likely to be audited by domestic entities. Second, multiple auditors are more likely for firms with high discretionary accruals. In addition, the estimates support the fact that foreign corporates are less likely to employ multiple auditors.

These findings would need to be viewed as preliminary, given the inherent limitations. For one, the study was confined to a single time point. A much richer analysis would need to allow for time-series data on a large cross-section of firms to enable more robust conclusions. Second, it is possible that over time, firms switch auditors or for that matter, employ multiple auditors. Whether and as to how such auditor switch impacts the results has not been explored, primarily owing to data limitations. Addressing such concerns comprise elements for future research.

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